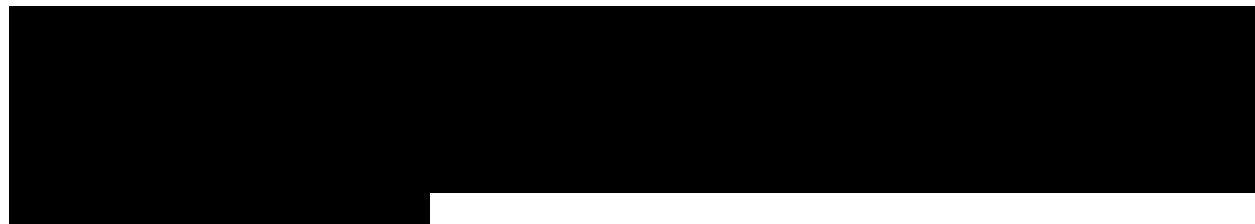


## INTERNAL REVENUE SERVICE

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3121.01-22



Dear [REDACTED]:

I am writing in response to your memorandum dated December 7, 2001, on behalf of your constituent, [REDACTED] (copy enclosed). [REDACTED] asked about recent proposed regulations addressing the application of employment taxes to statutory stock options. [REDACTED] is concerned that lower paid workers will feel the impact of the application of employment taxes to statutory stock options most strongly, and employers will have less incentive to offer such options to all employees.

Statutory stock options refer to:

- incentive stock options under section 422 of the Internal Revenue Code (Code); and
- options offered pursuant to an employee stock purchase plan under section 423 of the Code.

In this context, employment taxes refer to:

- the Federal Insurance Contributions Act (FICA) tax;
- the Federal Unemployment Tax Act (FUTA) tax; and
- Federal income tax withholding.

The preamble to the proposed regulations contains a detailed discussion of the statutory basis for applying employment taxes to statutory stock options. (See 66 Fed. Reg. 57023, Nov. 14, 2001). To summarize, the excess of the fair market value of the

stock received by the employee over the amount paid by the employee for the stock at the time he or she exercises an employer-provided stock option has long been held to be compensation income to the employee. (See *Commissioner v. Smith*, 324 U.S. 177 (1945) and *Commissioner v. LoBue*, 351 U.S. 243 (1956)).

Compensation income paid to an employee generally is treated as wages for employment tax purposes, absent a specific exclusion. Although certain Code provisions offer special income tax treatment to statutory stock options, no provisions in the employment tax portions of the Code exclude the compensation from wages. Therefore, compensation income received from the exercise of a statutory stock option generally is subject to employment taxes. The sole exception is the requirement of federal income tax withholding. Because federal income tax withholding is integrally tied to the payment of federal income tax, and because income for income tax purposes does not arise upon the exercise of a statutory stock option, income tax withholding is not applicable at that time.

We have responded to various taxpayer concerns about the application of employment taxes to statutory stock options, through the following guidance:

- Notice 2001-14 (2001-6 I.R.B. 516), issued on January 18, 2001, which established a moratorium on the application of employment taxes to statutory stock options, provided the exercise of the stock option occurs before January 1, 2003. This notice also provided that employers and employees who had paid the taxes could obtain refunds of the taxes paid, in order not to disadvantage those persons in comparison to employers and employees who had not paid the taxes. Notice 2001-14 also announced the IRS's intent to issue formal guidance on the application of employment taxes to statutory stock options.
- Formal guidance in the form of proposed regulations issued on November 13, 2001, which would apply the FICA and FUTA taxes at the time of exercise of a statutory stock option, but not federal income tax withholding. The proposed regulations would be effective for exercises of statutory stock options occurring on or after January 1, 2003.
- Notice 2001-72 (2001-49 I.R.B. 548), also issued on November 13, 2001, which addresses federal income tax withholding upon the sale or disposition of stock acquired through the exercise of a statutory stock option. Before Notice 2001-14, the IRS had enforced the application of federal income tax withholding upon a sale or disposition that resulted in compensation income to the employee. In response to taxpayer concerns about the difficulty of administering the withholding requirements, Notice 2001-72 proposes to exempt compensation received due to the sale or disposition of stock acquired through the exercise of a statutory stock

option from the federal income tax withholding requirements. However, employers would still be required to make reasonable efforts to report such compensation income on the employee's Form W-2.

- Notice 2001-73 (2001-49 I.R.B. 549), also issued November 13, 2001, which proposes rules of administrative convenience to assist employers in paying the FICA and FUTA taxes arising at the time of exercise of the statutory stock option. The intent of Notice 2001-73 is to give employers maximum flexibility in administering these taxes. This includes allowing an employer to treat the wage payment as paid at any time in the calendar year following the date of exercise. For example, the employer could treat all of the wage payments due to exercises of incentive stock options during the year by various employees as occurring on December 31. The employer could then prepare one FICA and FUTA tax calculation, and include the amounts on one return and with one deposit. In addition, employers could treat wage payments due to actual statutory stock option exercises in December as being paid in the first quarter of the next following year, providing flexibility in handling transactions occurring near the end of the year. Finally, Notice 2001-73 describes currently available payment methods that may assist employers and employees in meeting their employment tax obligations.

Your constituent raises concerns as to the potential effects on employers and employees of the application of employment taxes to statutory stock options. We tried to respond to those concerns to the extent possible, while still complying with the express provisions of the Code. Under both Notice 2001-14 issued in January, 2001, and the formal guidance issued in November, 2001, we established a lengthy moratorium during which we would not enforce the application of employment taxes to these types of stock options. One consideration for this extended period was to provide employers and payroll companies sufficient time to prepare to administer the payments. Another consideration was that the Congress may have concerns such as those raised by your constituent about the effects of the current Code provisions applying employment taxes to statutory stock options, and may wish to amend those provisions. I understand that legislation has been introduced which would exempt statutory stock options from employment taxes. Should such legislation be enacted, we will take the appropriate steps to implement the new provisions.

I hope that this information is helpful. If you have any further questions about the proposed guidance, please contact me at (202) 622-6010 or [REDACTED] of my staff at (202) 622-6040.

Sincerely,

Mary Oppenheimer  
Assistant Chief Counsel  
(Exempt Organizations / Employment Tax /  
Government Entities)  
Office of Division Counsel /  
Associate Chief Counsel  
(Tax Exempt and Government Entities)

Enclosure